No. 11397.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

In the Matter of

ABBOTT KINNEY COMPANY,

Alleged Bankrupt.

E. A. GERETY, WILLIAM HARRAH, CHARLES BROWN and HAROLD POOL,

Appellants,

vs.

ABBOTT KINNEY COMPANY,

Appellee.

APPELLEE'S BRIEF.

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Statement of Jurisdiction.

The United States District Court for the Southern District of California had jurisdiction over the parties and subject matter by reason of an amended involuntary petition in bankruptcy filed by three creditors against Abbot Kinney Company. (See Title 11, Chap. 2, Sec. 11, U. S. Code Ann., page 26, 1945 Cumulative Annual Pocket Part.)

This court has jurisdiction by reason of Sec. 24 (a) of the Bankruptcy Act, Title 11, Chap. 4, Sec. 47, U. S. Code Ann. (p. 360.)

Statement of Case and Questions Presented.

(a) Statement of Case.

Appellant's "Statement of Facts" in inadequate and in several instances untrue. For that reason Appellee cannot accept it.

The Abbot Kinney Company, a California corporation, on the 1st day of April, 1931, issued its Trust Indenture securing $350,000 First Mortgage 7% Sinking Fund Gold Bonds, due April 1, 1944 [R. 9], under which Trust Indenture, the California Trust Company was made trustee with the right to act for all bondholders [R. 585] excepting where the individual bondholders right of action arises out of collusion, fraud, wilful negligence or gross misconduct. [R. 591.] No interest was paid on said bonds from and after 1932 [R. 305], although enough of the bonds were retired so that as of Oct. 21, 1944, only $269,000 principal amount thereof were still outstanding. [R. 3, 6, 9, 142.]

$196,000 principal amount of said bonds were accumulated by J. F. Williams, William Harrah and I. Edward Robbins in a pool during the period from 1932 to 1937 [R. 508, 509] and were owned by them on Dec. 23, 1937, at which time they were deposited with California Trust Company under an agreement dated the 23rd day of December, 1937, by and between said J. F. Williams, I. Edward Robbins and William Harrah as the bond group, and Moses C. Davis, W. Thomas Davis and Alfred A. Newton as the stockholders group [R. 122.] (which agreement shall hereinafter be referred to as the pooling agreement). Pursuant to the terms of said pooling agreement, John Harrah, agent and father of William Harrah, and Lou Halper, agent for I. Edward Robbins [R.

324] were elected to the Board of Directors of Abbot Kinney Company as the nominees of the bond group and have served continuously in such capacity since that time. [R. 299, 508.]

In 1940, an Executive Committee of Abbot Kinney Company consisting of John Harrah, Carleton Kinney and Al Newton was appointed by the Board of Directors and given authority to carry on the business of Abbot Kinney Company between meetings of the Board of Directors. [R. 300.] This committee served until December, 1944, when it was dissolved. [R. 468.]

On June 2nd, 1931, Abbot Kinney Company and F. R. Cruickshank & Company entered into a conditional sales contract (hereinafter referred to as the sprinkling system contract) [R. 82] pursuant to which F. R. Cruickshank & Co. installed a sprinkling system on some of the property of Abbot Kinney Company at Venice, California. The sprinkling system contract provided in part that F. R. Cruickshank & Co. would retain title to the sprinkling system until the entire purchase price had been paid. [R. 90.] Prior to and at the time of the filing of the involuntary petition in bankruptcy in this matter, and at all times thereafter, Abbot Kinney Company was and still is in possession of said sprinkling system. [R. 17, 205.]

On Dec. 29th, 1937, the sprinkling system contract had long been in default showing an unpaid balance of $137,181.30 plus some accrued interest. [R. 303, 388.] On that date, it was modified so as to provide for payment of the balance in yearly installments of $30,000. [R. 98.] Nothing was paid thereon thereafter [R. 303] until the payments to the appellants herein, even though Hugh Darling, attorney for F. R. Cruickshank & Co., often re-

quested payment on account. [R. 304, 305, 318, 319, 510, 511.]

In January of 1943, Cruickshank & Co. offered to sell the sprinkling system contract for $10,000. [R. 491.] John Harrah took the position at the meeting of the Executive Committee which considered the offer, that he was primarily interested in the bonds and since the sprinkling system contract was junior to the bonds, there was nothing much that F. R. Cruickshank & Co. could do and therefore, the company should not make the purchase. [R. 492, 493.] This was the same position which Harrah had always theretofore taken when the value of the sprinkling system contract had been considered at Directors Meetings. [R. 513.] Carleton Kinney agreed with John Harrah and together they rejected the offer of Cruickshank & Co. [R. 493, 494.] and refused to purchase the sprinkling system contract for $10,000 even though Abbot Kinney Company was financially able to make the purchase. [R. 558, 559.]

It became apparent in the early part of 1944 to the other directors of Abbot Kinney Company that John Harrah and Carleton Kinney were operating the affairs of Abbot Kinney Company, through their control of the Executive Committee, for their own personal benefit and not for the best interests of Abbot Kinney Company. [R. 521.] A special meeting of the six remaining directors of Abbot Kinney Company (Hugh Darling having resigned) was called for May 3, 1944, for the purpose of dissolving the Executive Committee. Helen Kinney Ward, a nonresident director refused to come to California for the meeting. Also John Harrah and Carleton Kinney, knowing the purpose of the meeting, refused to attend so as to constitute a quorum. [R. 326, 469, 470.] There-

fore, it was impossible by means of a directors' meeting to dissolve the Executive Committee at that time. The Executive Committee therefore continued to carry on the affairs of the company [R. 470, 471] with John Harrah and Carleton Kinney continuing to act as a bloc. [R. 500.]

On June 6th, 1944, the offer to sell the sprinkling system contract for $10,000 was again renewed by Cruickshank & Co. Al Newton told E. A. Gerety (hereinafter referred to as Gerety) the General Manager of Abbot Kinney Company, of the offer and urged Gerety to help persuade John Harrah to vote for the acceptance of the offer, which Gerety agreed to do. [R. 496, 497.] Several days later, Al Newton saw John Harrah and urged him to vote in favor of the purchase. John Harrah stated that F. R. Cruickshank & Co. had no remedy except to take out the pipe and that it wasn't worth the cost of labor—also that no one else would buy the contract and the company could therefore purchase it at any time. [R. 497, 498.] Without contacting any other members of the Board of Directors to find out whether the Abbot Kinney Company should buy it, John Harrah again rejected the offer of Cruickshank & Co. to sell the sprinkling system contract for $10,000. [R. 325.]

During the time Al Newton was soliciting Gerety's aid to persuade John Harrah to accept the renewed offer of June 6th, 1944, of Cruickshank & Co. to sell the sprinkling system contract for $10,000, Gerety and Charles Brown (hereinafter referred to as Brown) were negotiating with Hugh Darling for the purchase of the sprinkling system contract. [R. 254, 448.] John Harrah knew this at the time Al Newton urged him to purchase it on behalf of the Abbot Kinney Company, having been so told by Brown. [R. 321 to 325 incl.]

On June 13th, 1944, Brown and Gerety completed the purchase of the sprinkling system contract for $15,000. [R. 256, 258.] The assignment was taken in the name of Brown alone [R. 260] although Gerety paid $5,000 of the purchase price. [R. 258.] Brown's portion of the purchase price was paid by two cashier's checks, issued on the same bank at the same time and made payable to the same person. [R. 289, 290, 571, 572.] The money for the two checks was obtained in part from a safe deposit box and in part from a checking account. Brown had no explanation for obtaining two cashier's checks instead of one although questioned at length thereon by Referee Brink. [R. 289 to 292 incl.] Before making the purchase, Brown knew that nothing had been paid upon the sprinkling system contract since 1932. [R. 253.] This fact had been pointed out to him by Gerety. [R. 245.]

On June 20th, 1944, with Gerety's knowledge and consent [R. 453], Brown demanded of Abbot Kinney Company payment of $7500 on account of the sprinkling system contract [R. 262] and threatened to turn the water off, as permitted in the sprinkling system contract, if it wasn't paid. [R. 266.] The figure of $7500 was suggested to Brown by Gerety. [R. 264.] John Harrah and Carleton Kinney as members of the Executive Committee, authorized the payment of the $7500 without an argument and without making any attempt to purchase the sprinkling system contract from Brown or compromise the balance of the obligation thereunder [R. 455] although they knew that only $15,000 had been paid for it. [R. 267, 371.] Al Newton was not present at the Executive Committee meeting which authorized the payment of $7500 and was not sure that such a meeting was ever held. [R. 499.] Gerety received $2500 as his share of the $7500 payment. [R. 456.]

Because of this payment of $7500 to Brown by John Harrah and Carleton Kinney, an involuntary petition in bankruptcy was filed against the Abbot Kinney Company on October 21, 1944, in the U. S. District Court by three bondholders, one of whom was Frank Williams, the largest single bondholder [R. 2 to 4 incl.], which alleged among other things that the total amount due on the bonds for principal and interest exceeded $500,000 and that the total reasonable value of all assets of Abbot Kinney Company did not equal $400,000. [R. 3.]

The Executive Committee immediately employed Harold Pool (hereinafter referred to as Pool), attorney for John Harrah, William Harrah [R. 250, 251] and Brown, as one of its attorneys to defend against the involuntary petition. Pool had theretofore conferred with Brown and had advised him on the purchase of the sprinkling system contract [R. 245] and the procedure Brown should follow in order to collect the $30,000 on account. [R. 269, 270, 272, 273.]

On November 8th, 1944, at 2 o'clock P.M., a special meeting of stockholders of Abbot Kinney Company was held and a new Board of Directors was elected. [R. 348.] Brown knew that there was to be a meeting. [R. 269.] John Harrah was informed several days in advance that the meeting was to be held. [R. 342.] John and William Harrah tried to prevent the meeting by having William Harrah forbid the voting trustees under the pooling agreement to vote a majority of the stock of Abbot Kinney Company at such meeting. [R. 348, 129.] This maneuver was defeated and the new Board was declared legally elected by a judgment of the Superior Court. [R. 465.]

On the morning of November 7th, 1944, John Harrah and Carleton Kinney purportedly held a meeting of the Executive Committee and after demand by Brown [R. 269, 270, 271] authorized the payment of an additional $30,000 on account of the sprinkling system contract. [R. 310, 343 to 354 incl., 486.] Carleton Kinney relied upon John Harrah's statement that the amount should be paid and voted in favor of its payment. [R. 485.] John Harrah and Carleton Kinney paid the $30,000 by check dated November 8, 1944, drawn in favor of Brown [R. 354] on the account of Abbot Kinney Company with Security First National Bank of Los Angeles. [R. 108.] Brown paid Gerety $10,000 of the $30,000. [R. 279.] Brown knew at the time he received the $30,000 that a petition in bankruptcy was then pending against the Abbot Kinney Company [R. 278], as did John Harrah [R. 350] and Gerety. [R. 460.] John Harrah was so anxious to make the payment of $30,000 to Brown that he didn't even ask the Abbot Kinney Company's attorney if he had the right to do it while the bankruptcy proceedings were pending. [R. 350.] Furthermore, John Harrah made the $30,000 payment even though he knew a special meeting of stockholders was being held the next afternoon for the purpose of electing new directors [R. 348] and without contacting any of the other directors of Abbot Kinney Company to ascertain their desires in the matter. [R. 351.] This readiness on the part of John Harrah to pay substantial sums on account of the sprinkling system contract when demanded by Brown was a complete reversal of the position taken by John Harrah during the time that F. R. Cruickshank & Co. owned it and made its many demands for payment. [R. 318, 319, 492, 493, 510, 511.] John Harrah, prior to Brown's acquisition thereof, always contended that the sprinkling

system contract was valueless and should not be purchased since it was junior to the bonds and would be wiped out on their foreclosure. [R. 318, 319, 492-494, 497, 498, 512.]

John Harrah was treasurer of Abbot Kinney Company in November, 1944. [R. 345.] Because of an outstanding judgment against Abbot Kinney Company which was being appealed, John Harrah had adopted the practice of putting the Abbot Kinney Company's money in cashier's checks and then holding them so that if execution were levied on the Abbot Kinney Company's bank account, the Abbot Kinney Company would not be put out of business. [R. 344.]

According to John Harrah, Brown learned from Gerety that the Company had about $40,000 on hand at the time the demand for the $30,000 was made. [R. 346, 347.]

In order to meet the check for $30,000 given to Brown, John Harrah deposited the cashier's checks in his possession to the account of Abbot Kinney Company. [R. 354, 355.]

Gerety was first employed as Manager of Abbot Kinney Company in 1926. [R. 433.] He served in that capacity until 1933, at which time Abbot Kinney Company went into receivership and Gerety was apointed Receiver. [R. 434.] He acted as Receiver until the fall of 1937, at which time Abbot Kinney Company filed a petition under 77 b of the Bankruptcy Act. Gerety was then appointed Trustee in that proceeding which was dismissed within four or five months. Gerety was again employed as Manager which position he continuously filled until November 30, 1944. [R. 435-36.] His salary as Manager was $500 per month. [R. 436.]

Gerety had the duties of a general manager including the right to hire and fire, negotiate for the rental of property subject to approval or rejection of the Board of Directors or Executive Committee and to otherwise carry on the normal business of the Company. [R. 436-446, incl., 490.]

At the time the sprinkling system contract was purportedly purchased by Brown, Gerety knew the amount of money Abbot Kinney Company had on hand because its books were under his jurisdiction. [R. 450.] Soon after the sprinkling system contract was purchased, Gerety told Al Newton that Brown and "somebody else" had asked him (Gerety) to participate in the purchase. Gerety would not identify the "somebody else" as William Harrah. [R. 499.] John Harrah and Carleton Kinney knew that Gerety owned an interest in the sprinkling system contract on the date the demand for payment of $7500 was made. The Executive Committee never asked Gerety what he would take to settle the sprinkling system contract in full. [R. 455.] At the time demand was made for the $30,000, Gerety knew that a petition in bankruptcy had been filed against the Abbot Kinney Company. [R. 460-1.] According to Gerety, Abbot Kinney Company had approximately $38,000 in its treasury at the time the $30,000 was paid. [R. 461.] Not long after Gerety received his share of the $30,000, his employment with Abbot Kinney Company terminated because the new Board of Directors had been elected. [R. 464-5.]

On April 13, 1937, John Harrah filed a personal voluntary petition in bankruptcy. He never obtained a discharge in those proceedings, however, because of an adverse report by the Referee, although he applied for it. [R. 297.] From that date on, John Harrah never car-

ried on a business in his own name except a limited law practice. [R. 297, 298.] He thereafter purportedly devoted his time to the interests of his son William Harrah. [R. 296, 297.] However, the relationship was very confusing and it was difficult to know whether he was acting for William Harrah or himself. [R. 518.]

John and William Harrah had absolute confidence in Brown. [R. 369.] He was their intimate personal friend [R. 212], and they trusted him to the fullest. [R. 370.]

From and after John Harrah's failure to receive a discharge in bankruptcy, William Harrah's, John Harrah's and Brown's business affairs interweave. [R. 294, 295, 327, 328, 215, 216, 218, 219, 233, 234, 517, 501-505, 523, 524.] Brown worked for William Harrah on different occasions thereafter. [R. 294, 295.] Once as bartender, [R. 327-8] then in a retail liquor store. [R. 215-16.] Also Brown bought merchandise for William Harrah's Reno business and ran errands for William Harrah when requested. [R. 218-19.] Brown commingled William Harrah's supplies with his own. [R. 217.] He had access jointly with John Harrah to William Harrah's safe in Venice. [R. 367.] Brown could take money out of the safe at any time and deal with it as he saw fit. [R. 233, 234, 517.] John Harrah used this same safe to keep Abbot Kinney Company's cashier's checks. [R. 369.] John Harrah would negotiate business deals for William Harrah and would then turn them over to Brown. [R. 501-505.] Also, John Harrah favored Brown with leases from Abbot Kinney Company. [R. 236, 237, 506-507.] After Brown purportedly purchased the sprinkling system contract and prior to the payment of the $30,000

on account, John Harrah "controlled it" and offered to sell to Frank Williams and I. Edward Robbins the same percentage of interest therein as they each held in the bond pool. [R. 514, 515, 523, 524.] Brown always sought John Harrah's advice on how to conduct his business in the Robbins Building. [R. 240.] During the process of acquiring the sprinkling system contract, Brown talked to John Harrah about its value. [R. 249.] John Harrah explained to Brown how Brown could expect to be paid by Abbot Kinney Company and from what sources the money would come. [R. 252.] Merely because William Harrah indicated the desire, Brown purportedly sold to him for the sum of $3000, a $27,000 interest in the sprinkling system contract upon which Brown and Gerety had only recently received $37,000. [R. 280-5, incl.]

Brown's assets were very limited. He arrived in Venice in 1936 with between five and eight thousand dollars. [R. 232.] None of his activities were particularly profitable thereafter until John Harrah gave him leases from Abbott Kinney Company in the latter part of 1943. [R. 221-232, incl.] He worked for Abbot Kinney Company for $40.00 per month in 1943 [R. 220], and for William Harrah, in his liquor store, for $40.00 per week. [R. 234.]

Brown knew that John Harrah had been a director of Abbott Kinney Company since 1940. He also knew that John Harrah had been a member of the Executive Committee since 1942 and served in that capacity until December, 1944. [R. 235.] Brown also knew that Gerety was the Manager of Abbot Kinney Company from at least 1940 to Gerety's discharge in November of 1944,

and that Gerety was in full charge of the activities of Abbot Kinney Company. [R. 241.]

According to Brown, Gerety called the sprinkling system contract to Brown's attention and also was the one who made the date with Hugh Darling to discuss its purchase. [R. 242.] Brown knew that the sprinkling system contract had been offered to the Abbot Kinney Company for $10,000 before he purportedly purchased it. [R. 243.]

After the new Board of Directors of Abbot Kinney Company was elected on November 8, 1944, Harold Pool and associate were dismissed as attorneys for Abbot Kinney Company and Grainger & Hunt were employed in their place.

An Order directed to Brown to show cause why he should not repay the $30,000 to Abbot Kinney Company, was obtained on the petition of the petitioning creditors in the above entitled matter. [R. 24.] Before the order to show cause came on for hearing and by stipulation approved by the court and entered into by and between the petitioning creditors, Brown, and Abbot Kinney Company, the $30,000 was placed by Brown in custody of the Clerk of the District Court as a court of bankruptcy and the order to show cause was discharged without prejudice. [R. 24-28, incl.]

Thereafter, it became apparent to the Abbot Kinney Company and the petitioning creditors that the only real issue between them on the petition in involuntary bankruptcy was the solvency or insolvency of Abbot Kinney Company. Abbot Kinney Company was willing to concede that it was insolvent and should be declared a bankrupt if most of the $30,000 belonged to Appellants herein

and Abbot Kinney Company owed a balance of $80,000 on the sprinkling system contract. Also the petitioning creditors were willing to concede that Abbot Kinney Company was not insolvent and should not be declared a bankrupt if most of the $30,000 belonged to Abbot Kinney Company and Abbot Kinney Company owned the sprinkling system free and clear of liability. [R. 155.]

Therefore, in order to obtain a judicial determination of the respective rights of the parties in and to the $30,000 on deposit and the sprinkling system, which would be binding upon all parties involved and would be conclusive on the question of insolvency, Referee in Bankruptcy, Hugh L. Dickson, upon the petition of Abbot Kinney Company [R. 17-23, incl.], issued an order on the 7th day of July, 1945, which, among other things, required the appellants herein and John Harrah to show cause why an order should not be entered (1) adjudging Abbot Kinney Company to be the owner of the sprinkling system and (2) directing the Clerk of the court to pay to Abbot Kinney Company, the sum of $30,000. [R. 29-30.] Petitioning creditors joined forces with Abbot Kinney Company on the hearing of the said order to show cause. [R. 29.]

At the commencement of the hearing of the said order to show cause, John Harrah orally disclaimed any interest in the sprinkling system and in the $30,000. [R. 198.] The appellants herein filed written answers to the order to show cause and the petition upon which it was issued. [R. 31-41, incl.] Brown and Gerety filed written objections to the jurisdiction of the Bankruptcy Court to hear and determine the issues raised by the order to show cause and the petition upon which it was

issued. [R. 42-44, incl.] William Harrah orally adopted said objections to jurisdiction. [R. 202.]

The order to show cause and the objections to jurisdiction of the Bankruptcy Court, came on for hearing before Referee Dickson on July 23, 1945. The objections to jurisdiction were overruled by him. [R. 202, 203.] Thereupon it was suggested by one of the counsel in the case that Referee Dickson was disqualified by reason of prejudice to proceed with the matter. Referee Dickson stated that he was free of bias, but that since the question had been raised, he would request Referee Benno Brink to proceed with the matter. No objection being made, the matter was taken over by Referee Benno Brink and in due course appropriate orders of reference were made. [R. 12, 13.]

Referee Benno Brink began the hearing on the order to show cause, the petition upon which it was issued and the answers thereto, on July 24, 1945. At the commencement of the hearing, appellants herein renewed their aforesaid objections to the jurisdiction of the Bankruptcy Court. Referee Brink concurred in Referee Dickson's ruling and again overruled the objections. [R. 202, 203.]

At the completion of the hearing and after excoriating appellants herein and John Harrah for the unconscionable conspiracy and confederation to defraud and cheat Abbot Kinney Company in which they had participated [R. 605-610, incl.], Referee Brink announced his decision from the bench, holding (1) that Brown and anyone associated with him could not collect a greater sum from Abbot Kinney Company on the sprinkling system contract than they had paid for it, to wit: $15,000.00; (2) that, since Brown had received $7500 on account in June

of 1944, the $30,000 payment, which was made after the filing of the involuntary petition in bankruptcy, was valid only to the extent of $7500 and invalid as to the remaining $22,500; (3) that, accordingly, the Clerk of the Court should deliver to Brown $7500 and to Abbot Kinney Company $22,500 of the $30,000 deposited with him. [R. 610, 611.]

On August 23, 1945, Referee Benno Brink signed and filed his written Findings of Fact, Conclusions of Law and Order in the matter [R. 61-79, incl.], which, among other things, found and held the following: (1) that prior to and at the time of the filing of the involuntary petition in bankruptcy and continuously since then, Abbot Kinney Company was in possession of the sprinking system [Finding VIII, R. 65]; (2) that sometime prior to the 13th of June, 1944, at the instance and instigation of John Harrah, an unconscionable conspiracy was knowingly, wilfully and fraudulently entered into between John Harrah, William Harrah, Brown and Gerety, to defraud and cheat Abbot Kinney Company by having the Executive Committee refuse to purchase the sprinkling system contract, and to have Brown, as undisclosed agent of the conspirators, purchase the sprinkling system contract at as low a figure as he could negotiate and to thereafter have the Executive Committee, through the influence of John Harrah, authorize and order the payment to Brown, of said sprinkling system contract as rapidly as money was available [Finding XII, R. 66]; (3) that in furtherance of said conspiracy, John Harrah and Carleton Kinney fraudulently and wilfully refused to accept an offer made by Cruickshank & Company on or about June 6, 1944, to sell the sprinkling system contract for $10,000 [Finding XIV, R 67]; (4) that thereafter in

furtherance of the conspiracy, Brown obtained an assignment of said sprinkling system contract in his own name [Finding XV, R. 67]; (5) that in furtherance of the conspiracy, Brown was paid $7500 on June 20, 1944, and $30,000 on November 7, 1944, on account of said sprinkling system contract [Findings XVIII and XX, R. 68, 69, 70]; (6) that during all of the above mentioned transactions, John Harrah and Gerety held fiduciary positions with the Abbot Kinney Company and were not free to act contrary or antagonistic to the best interests of Abbot Kinney Company [Finding XXIII, R. 71]; (7) that Abbot Kinney Company was financially able to buy the sprinkling system contract for $10,000 on June 6, 1944, and would have done so if it had not been prevented by the conspiracy instigated, conceived and executed by John Harrah with the help, assistance and connivance of William Harrah, Gerety and Brown [Finding XXIV, R. 71]; (8) that the written assignment of the sprinkling system contract was taken in the name of Brown for the purpose of misleading Abbot Kinney Company and its directors and officers, other than John Harrah, of the interest therein held by John Harrah, William Harrah and Gerety [Finding XXV, R. 71]; (9) that all acts in connection with the acquisition of and payment on account of the sprinkling system contract were in violation of the fiduciary obligations and duties owed by Gerety and John Harrah to Abbot Kinney Company, of which Brown and William Harrah well knew and were done for the purpose of defrauding and cheating Abbot Kinney Company [Finding XXVI, R. 72]; (10) that on the 30th day of November, 1944, William Harrah advised Abbot Kinney Company in writing that he had purchased a one-third interest in the unpaid balance due on the sprinkling system

contract on the 26th day of November, 1944, which notice was sent to Abbot Kinney Company in furtherance of the conspiracy and for the purpose of misleading Abbot Kinney Company as to the date on which said William Harrah obtained his interest in the sprinkling system contract [Finding XXVIII, R. 72]; (11) that Abbot Kinney Company owns the sprinkling system free and clear of the sprinkling system contract; and (12) that Abbot Kinney Company is entitled to receive $22,500 of the $30,000 on deposit with the Clerk of the court, as a court of bankruptcy, and Brown and Gerety are entitled to receive the remaining $7500. [Finding XXXII, R. 74.]

The appellants herein then petitioned for review of said order of August 23, 1945, of Referee Benno Brink. [R. 45.] Thereafter and on the 27th day of May, 1946, the Hon. J. F. T. O'Connor, Judge of the District Court, filed his Memorandum Order [R. 178] in which he approved, adopted and accepted the Findings of Fact, Conclusions of Law and Order of the Referee, excepting only those which provided that Brown should receive $7500 of the $30,000 on deposit, as to which he reversed. In lieu thereof, Judge O'Connor ordered that only $2500 be delivered to Brown. Judge O'Connor adopted the position (which was the same as that urged by Appellee herein at the trial of the matter before Referee Benno Brink [R. 595]) that the most Brown could receive from Abbot Kinney Company on the sprinkling system contract was $10,000 since it was through his conspiracy with John Harrah and the other appellants herein that Abbot Kinney Company was fraudulently deprived and cheated of purchasing the sprinkling system contract for $10,000. [R. 183, 184.]

Thereafter, and on the 17th day of June, 1946, Judge O'Connor signed and filed his formal written order on

review from the order of the Referee which provided in part that (1) Abbot Kinney Company owned the sprinkling system free and clear of the sprinkling system contract; (2) that the Clerk of the court, as a court of bankruptcy, should forthwith turn over and deliver to Abbot Kinney Company, $27,500 of the $30,000 on deposit, and to Brown the remaining $2500. [R. 190, 191, 192.]

It is from this order that the appellants herein take this appeal. [R. 193.]

(b) Questions Presented.

1. Did the United States District Court, sitting as a court of bankruptcy, have jurisdiction to hear and determine the controversy and make the order which is the subject matter of this appeal?

The question is raised by objection to jurisdiction in re order to show cause dated July 7, 1945, filed by appellants herein [R. 42 and 43], and by "APPELLANTS' STATEMENT OF POINTS ON WHICH THEY INTEND TO RELY." [R. 613.]

2. Did the evidence introduced herein sustain and support the findings of fact and conclusions of law of the United States District Court, sitting as a court of bankruptcy?

The question is raised by "APPELLANTS' STATEMENT OF POINTS ON WHICH THEY INTEND TO RELY." [R. 614.]

3. Did the District Court err in modifying the findings of the Referee?

The question is raised by "APPELLANTS' STATEMENT OF POINTS ON WHICH THEY INTEND TO RELY." [R. 614.]

ARGUMENT.

I.

The District Court Had Jurisdiction to Entertain This Bankruptcy Proceeding.

A creditors' petition in involuntary bankruptcy was filed in the District Court of the United States, Southern District of California, Central Division. Thereafter, a creditors' first amended involuntary petition was filed which alleged: the necessary facts to show venue and that Abbot Kinney Company was a corporation subject to the National Bankruptcy Act and not excepted thereby; that Abbot Kinney Company was insolvent; that each of the three petitioning creditors had a provable general unsecured claim against the corporation, fixed as to liability and liquidated in amount, which in the aggregate amounted to more than $500.00 over and above the value of securities held by them; that within four months preceding the filing of the original petition, Abbot Kinney Company, while insolvent, committed an act of bankruptcy in that it paid out certain of its assets to certain individuals on an intecedent debt; and that the payment was made for the purpose and with the intent of preferring said individuals over other creditors of the Company. [R. 5.]

Thereafter, an answer was filed by Abbot Kinney Company [R. 8] and later an amended answer was filed [R. 141].

The amended involuntary petition, and the amended answer put in issue the following points: (a) the solvency of Abbot Kinney Company; (b) the qualification of the petitioning creditors; (c) the commission of an act of bankruptcy. Upon the hearing of the issues raised

by said pleadings, Abbot Kinney Company in effect abandoned all of its defenses to the involuntary petition, except the defense of solvency. [R. 155.]

Under the above situation, Appellee respectfully submits that the jurisdiction of the District Court attached at the time of the filing of the petition in bankruptcy. From that moment, the said District Court under Section 2 of the Bankruptcy Act had full and complete jurisdiction as to the matters set forth under said section.

Appellants insist, however, that the three individuals who filed the involuntary petition were not qualified creditors, and hence there was no jurisdiction in the court. As heretofore pointed out, the creditors alleged that they had claims, fixed as to liability and liquidated as to amount, which fact was denied at the beginning by Abbot Kinney Company. The jurisdiction of this court was not dependent on whether these creditors had such claims—it had the jurisdiction to determine whether they had such claims. That was one of the issues at the outset of the case to be determined. Whether the court made a correct determination of that matter would go to the correctness of the decision and not to the jurisdiction of the court.

Appellants further assert that the petition did not state an act of bankruptcy, therefore there was no jurisdiction. Appellee further submits that the allegations of the petition in this respect apprised Abbot Kinney Company that because certain payments had been made within four months prior to the filing of the petition that petitioners claimed a preference had been effected in favor of one creditor over other creditors, and that an act of bankruptcy had thereby been committed. These allegations

complied with the general rules of pleading established by rules of Civil Procedure Rule 8. If the alleged bankrupt had desired more particularly in respect to either the qualification of creditors, or the act of bankruptcy, it could by appropriate motion have sought the same. This it did not do, but rather chose to answer. By so doing, it cured any defect as to particularity of statement, if any.

Collier on Bankruptcy, 14th Edition, Vol. 2, p. 91.

In Matter of S. W. Straus & Co., Inc. (C. C. A. 2), 67 F. (2d) 605, 24 A. B. R. (N. S.) 234, it was said (p. 609):

> "The petition in bankruptcy charged as the only act of bankruptcy the giving of preferences to unknown creditors in unknown amounts, aggregating $2500.00. Except in stating a different aggregate sum, it is identically like the petition held insufficient by this court in Re Gaynor Homes (C. C. A. 2d Cor.), 23 Am. B. R. (N. S.) 654, 65 Fed. (2d) 378. Hence the petition was subject to dismissal had the objection been taken in time. But as our previous decisions indicate, such a petition gives the court jurisdiction, and the defect is one which may be waived by answer and going to trial."

Appellants further object to the qualification of the petitioning creditors on two other grounds, viz., that their claims were barred by the statute of limitations, and were such that only the trustee under the bond indenture, of which their bonds were a portion, could maintain an action.

In respect to the statute of limitations, the involuntary petition states that the bonds were due April 1, 1944 [R.

6], which, if true, would be a complete answer to any claim that the statute of limitations was a barrier to the enforcement of the bonds. It is manifest that the statute of limitation question was one for determination in the trial of the involuntary petition, and depended on the evidence adduced at such hearing. It could not go to the jurisdiction of the court to entertain the bankruptcy proceeding.

In respect to the ownership of the bonds, there is nothing in the involuntary petition to indicate other than that the creditors were the owners thereof. By virtue of fragmentary evidence, to wit, one paragraph in the trust indenture, which provides that rights of action on or because of the bonds and the trust indenture are vested in the trustee, except as otherwise provided in the indenture, Appellants urge that the creditors owned no debts. (Op. Br. 14.) They overlook other provisions of the bond indenture, however, one of which reads, "Provided, however, that nothing contained herein shall defeat the right of an individual bondholder to pursue his legal right of equitable remedy where his right of action arises out of collusion, fraud, wilful negligence, or gross misconduct." [R. 591.]

Said trust indenture also provides [R. 585-586]:

> "Section III: No holder of any bond or coupon secured hereby shall have the right to institute any suit, action or proceeding at law or in equity, upon or in respect of this Indenture or for the execution (448) of any trust or power hereof or for the appointment of a receiver or for any other remedy under or upon this Indenture, unless such holder shall previously have given to the Trustee written notice of an event of default, and unless also the holders of twenty-five (25%) percent in amount of

the bonds secured hereby then outstanding shall have made written request upon the Trustee and shall have afforded to it a reasonable opportunity either to proceed itself to exercise the power hereinbefore granted, or to institute such action, suit or proceeding in itself or may, and unless also such holders shall have offered to the Trustee reasonable security and indemnity against costs, expenses and liabilities to be incurred in or by reason of such action, suit or proceeding; and the Trustee shall have refused or neglected to comply with such request within a reasonable time thereafter. Such modification, request and offer of indemnity are hereby declared in every case at the option of the Trustee to be conditions precedent to the execution of the actions and trust of this Indenture and to any action or cause of action for foreclosure or for any other remedy hereunder. It is understood, intended and hereby provided that no one or more holders of bonds or coupons shall have any right in any manner whatever (449) to affect, disturb or prejudice the lien of this Indenture by his or their action, or to enforce any right hereunder, except in the manner herein provided, and that all proceedings hereunder shall be instituted, had and maintained in the manner herein provided for the equal benefit of all holders of such outstanding bonds and coupons."

In the Matter of Hudson Coal Co., Debtor (U. S. D. C. Middle District of Pa.), 22 Fed. Supp. 768, 36 A. B. A. (N. S.) 896, it was contended that bondholders had no standing by reason of provisions in the mortgage to institute a suit unless it shall previously have delivered to the trustee written notice of default, or unless holders of 20% of the bonds shall have requested the trustee in writing to take action, and that no one or more holders

of bonds shall have any right in any manner whatever to disturb or prejudice the lien of the mortgage or enforce any writ thereunder, excepting in the manner therein provided. The court in said case, said (p. 770):

> "On the first question, the standing of the creditor petitioners under the provisions of the mortgage to institute this proceeding under Section 77B of the Bankruptcy Act, the court is of the opinion that the provisions of the mortgage invoked in the answers of the Hudson Coal Company, debtor, and the intervening bondholders, relate to a foreclosure of the mortgage and the disturbance of the lien of the mortgage and not to a proceeding under section 77B of the Bankruptcy Act. The objection that the petitioning creditors have no standing to institute this proceeding on the ground of the provisions cited in the mortgage and the request for dismissal on this ground must, therefore, be overruled."

It thus appears that the objections raised by Appellants do not go to the jurisdiction of the court in respect to this bankruptcy proceeding, but at most deal with problems which should be determined at the trial of the involuntary petition and the answer thereto.

The jurisdiction of the bankruptcy court is likewise not dependent upon the precision of the pleadings, but comes from the statute itself.

Collier on Bankruptcy, 14th Ed. Vol. 2, pages 13 to 16, contains an excellent discussion on this point. In part, it is there said,

> "Many courts have held that jurisdiction in a proceeding for adjudication in bankruptcy 'comes from the statutes and is not conferred by the accuracy and precision of the averments made in the

petition.' Such a statement suggests the view that a defect in the pleading does not touch upon the court's power to proceed but only affects the petitioner's cause of action. No doubt such a view is commendable, inasmuch as it eliminates from the domain of pleading the dangers lurking behind such phrases as 'jurisdictional fact' and the like—

"It is quite evident that viewed in this varied context, the question of what is a 'jurisdictional fact' for purposes of pleading is not susceptible of any precise answer. There is no basis for assuming that the pleading of an act of bankruptcy, for instance, is any more 'jurisdictional' than the pleading of a petitioning creditor's claim. Nor is it reasonable to suppose, on reading the Act and the General Orders, that a given defect in pleading might be 'jurisdictional'—in any sense previously indicated—at one stage of the proceedings, and 'non-jurisdictional' at a subsequent state. Far more preferable is the view that defects in pleading are not 'jurisdictional'; that whether or not they may be cured depends upon the power of amendment, and that a bankruptcy court has ample jurisdiction to permit amendments. Aside from a few isolated instances, judicial opinion amply supports these views."

It is said in *Re Shoesmith* (C. C. A. 7), 13 A. B. R. 645, 135 Fed. 684, p. 688:

"Another question suggested at the argument has relation to the jurisdiction of the court below. It is contended that because the first petition filed by the creditor was defective, and a sufficient amended petition was filed more than four months after the last fraudulent transfer of the property, the court had no power to permit an amendment, and was therefore without jurisdiction to entertain the proceedings.

The District Court had jurisdiction of the parties. It had jurisdiction of the subject-matter. It has general and exclusive jurisdiction of bankruptcy proceedings. The objection goes to the want of equity exhibited by the petition, not to the want of power in the court. There was jurisdiction to determine the sufficiency of the petition, and it was complete to permit any amendment. The jurisdiction in such cases comes from the statute, and is not conferred by the accuracy and precision of the averments made in the petition."

In re Plymouth Cordage Co., et al., 13 Am. B. R. 665, p. 670, 135 Fed. 1000 (C. C. A. 8), it is said (p. 1004):

"The truth is that the contention of counsel for the respondent fails to distinguish between the averments essential to jurisdiction over the subject-matter and the parties and those requisite to invoke a favorable adjudication upon the petition. Jurisdiction of the subject-matter and of the parties is the right to hear and determine the suit or proceeding in favor of or against the parties to it. The facts essential to invoke this jurisdiction differ materially from those essential to constitute a good cause of action for the relief sought. A defective petition in bankruptcy or an insufficient complaint at law, accompanied by proper service upon the defendants, gives jurisdiction to the court to determine the questions it presents, although it may not contain averments which entitled the complainant to any relief; and it may be the duty of the court to determine either the question of its jurisdiction or the merits of the controversy against the petitioner or plaintiff."

In re First National Bank of Belle Fourche, 18 A. B. R. 265, 152 Fed. 64 (C. C. A. 8), the court after discussing a defective petition in bankruptcy, states (p. 69):

> "The facts which conditioned the jurisdiction of the court were the filing of the petition and the service of the subpoena."

II.

Rights in and to Property in the Possession of the Alleged Bankrupt at the Time of the Institution of a Bankruptcy Proceeding Are Subject to Summary Determination in the Bankruptcy Court.

Upon the filing of an involuntary petition, the bankruptcy court draws to itself the exclusive jurisdiction to determine all questions concerning the right, title or interest in or to property in the possession of the alleged bankrupt at that time, or later coming into the possession of the court. The above proposition is thoroughly established.

In *Murphy v. Hofman,* 211 U. S. 562, 53 L. Ed. 327, 28 S. Ct. 154, 21 A. B. R. 487, it is said (p. 568):

> "But, where the property in dispute is in the actual possession of the court of bankruptcy, there comes into play another principle, not peculiar to courts of bankruptcy, but applicable to all courts, Federal or State. Where a court of competent jurisdiction has taken property into its possesion, through its officers, the property is thereby withdrawn from the

jurisdiction of all other courts. The court, having possession of the property, has an ancillary jurisdiction to hear and determine all questions respecting the title, possession, or control of the property. In the courts of the United States this ancillary jurisdiction may be exercised, though it is not authorized by any statute. The jurisdiction in such cases arises out of the possession of the property, and is exclusive of the jurisdiction of all other courts, although otherwise the controversy would be cognizable in them. Wabash R. Co. v. Adelbert College, 208 U. S. 38, 52 L. Ed. 379, 386, 28 S. Ct. 182. . . .

Accordingly, where property was in the possession of the bankrupt at the time of the appointment of a receiver it was held that the bankruptcy court had jurisdiction to determine the title to it as against an adverse claimant, and that the receiver had no right to deliver it to him without the order of the court. Whitney v. Wenman, 198 U. S. 539, 49 L. Ed. 1157, 25 S. Ct. 778, 14 A. B. R. 45."

In *Isaacs v. Hobbs, Tie & Timber Co.*, 282 U. S. 734, 75 L. Ed. 645, 51 S. Ct. 270, 17 A. B. R. (N. S.) it is said:

"This is but an application of the well recognized rule that when a court of competent jurisdiction takes possession of property through its officers, this withdraws the property from the jurisdiction of all other courts, which, though of concurrent jurisdiction, may not disturb that possession; and that the court originally acquiring jurisdiction is competent to hear

and determine all questions respecting title, possession and control of the property."

In re Baldwin, 291 U. S. 610, 78 L. Ed. 1020, 54 S. Ct. 551, 24 Am. B. R. (N. S.) 487, it is said (p. 615):

> "All property in the possession of a bankrupt of which he claims the ownership passes, upon the filing of a petition in bankruptcy, into the custody of the court of bankruptcy. To protect its jurisdiction from interference, that court may issue an injunction. The power is not peculiar to bankruptcy or to the federal courts. It is an application of the general principle that where a court of competent jurisdiction has, through its officers taken property into its possession, the property is thereby withdrawn from the jurisdiction of other courts. Having possession, the court may not only issue all writs necessary to protect its possession from physical interference, but is entitled to determine all questions respecting same. . . . The jurisdiction in such cases is exclusive of the jurisdiction of other courts, although otherwise the controversy would be cognizable in them."

Because of the exclusive nature of the jurisdiction of the bankruptcy court, Abbott Kinney Company could have resorted to no other court to protect its interest in connection with the fraud perpetrated by appellants and John Harrah because both the sprinkling system and the $30,000 which are in dispute herein were in the possession of Abbot Kinney Company at the time of the filing of the involuntary petition in bankruptcy. [R. 17, 205; Op. Br. 7.]

III.

The Alleged Bankrupt Was a Proper Party to Institute These Proceedings.

Appellants argue that the alleged bankrupt cannot institute proceedings to recover a preference and to quiet title and establish a trust against an adverse claimant prior to adjudication. (Op. Br. 19.) Such argument is untenable herein, however, since it is not a preference that is sought to be recovered. Furthermore, appellants are not adverse claimants in the sense that term commonly denotes, namely, parties asserting rights to property *not* in possession of the bankruptcy court. This is a proceeding to adjudicate the rights of parties to properties in the possession of the bankruptcy court, and to a fund held by the alleged bankrupt at the time of the institution of the bankruptcy proceedings, and now in actual possession of the Clerk of the Bankruptcy Court. Generally, Appellants claim that the right to institute proceedings lies only in a receiver or a trustee, and not in the alleged bankrupt. They argue that because the act conferring powers on the receivers and the trustees says nothing about the bankrupt, that it must follow that the bankrupt has no such right. Receivers and Trustees are officers of the court, whose powers are conferred by statute, and thus it was necessary to specifically grant such powers. Such was not the situation with the bankrupt.

In Collier on Bankruptcy, 14th Edition, Vol. 1, on page 1176, it is said:

> "Section 11c is silent as to the right of the bankrupt himself to begin a suit in the time which intervenes between the filing of the petition and the appointment and qualification of the trustee, but the

weight of authority is that since the bankrupt is not divested of his title under Sec. 70a until such appointment and qualification, he may commence a suit or proceeding during that interval."

In *Johnson v. Collier,* 222 U. S. 538, at 539 and 540, it is said:

"While for many purposes the filing of the petition operates in the nature of an attachment upon choses in action and other property of the bankrupt, yet his title is not thereby divested. He is still the owner, though holding in trust until the appointment and qualification of the trustee, who thereupon becomes 'vested by operation of law with the title of the bankrupt' as of the date of adjudication.

"Until such election the bankrupt has title-defeasible, but sufficient to authorize the institution and maintenance of a suit on any cause of action otherwise possessed by him. It is to the interest of all concerned that this should be so. There must always some time elapse between the filing of the petition and the meeting of the creditors. During that period it may frequently be important that action should be commenced, attachments and garnishments issued, and proceedings taken to recover what would be lost if it were necessary to wait until the trustee was elected."

To the same effect is *Danciger and Emerich Oil Company v. Smith,* 276 U. S. 542, and a number of other cases cited on page 1176 of Vol. 1, 14th Edition of Collier on Bankruptcy in support of the quotation above given.

Appellants state that a dangerous precedent will be established and departure from rule had, if the bankrupt is permitted, prior to an adjudication, to litigate over assets

of the estate. As is disclosed from the foregoing quotation from Collier, and the decisions of the United States Supreme Court, instead of a precedent, the established rule is that such proceeding may be instituted. As a matter of fact, it would be dangerous precedent to establish a rule that such litigation might not be instituted since property might be lost to the estate if the bankrupt were not permitted to instituted such litigation.

Authorities cited by Appellants are not in point. (Op. Br. 19-23.) Section 23(b) of the Bankruptcy Act simply provides for the forum for suits by the receiver or trustee. It does not deal with summary proceedings brought in the bankruptcy court in relation to property in possession of the court. Section 60 of the Bankruptcy Act merely defines preferences, and provides for their avoidance by the trustee. Other cases cited deal with rights conferred upon the trustee. Also cases are quoted which show that a receiver, prior to the amendment of 1938, could not institute action. That is because a receiver is an officer of the court, and his powers are limited by statute and prior to 1938 no such power had been conferred upon receivers. This is not the case, however, with respect to the bankrupt as heretofore set forth. *In re Vancouver Book & Stationery Co. Inc.,* 48 Fed. Supp. 799, relied on by appellants, likewise deals with a preference. In the present case the element of a preference is not involved. This cause of action is based on the fraud of the appellants and John Harrah and the violation of fiduciary duties. Hence the right of recovery is not one that exists only by virtue of the bankruptcy act, and is not one that is dependent on the solvency or insolvency of the bankrupt.

IV.

The Court Did Not Err in Denying a Creditor the Right to Intervene and Oppose the Involuntary Petition. Furthermore Such Matter Is Not Properly Before the Court on This Appeal.

Appellants urge that the court erred in denying a creditor the right to intervene and in not granting the motion to dismiss the involuntary petition. (Op. Br. 29.) The petition to intervene and the motion made were not part of the proceeding in connection with the order which is the subject matter of this appeal. They were collateral matters in connection with the involuntary proceeding in bankruptcy, and no appeal has been taken from the order made in respect thereto. Consequently, we fail to see how the same are pertinent herein. However, it is plain that the court below was correct in its ruling in regard to such petition and motion.

Prior to 1938, and before the amendment to the National Bankruptcy Act by the Chandler Act, a creditor had the right under Sec. 18b of the Bankruptcy Act to plead to the involuntary petition in bankruptcy in opposition thereto. Section 18b was amended so as to take away that right.

In the *Matter of George A. Carden, Bankrupt* (C. C. A. 2), 118 F. (2d) 677, 45 Am. B. R. (N. S.) 258, the court had occasion to consider the effect of the amendment. This was a case where an involuntary petition, signed by the petitioning creditors about a year before it was filed, lay dormant without service for some years, and when an order was obtained for an alias subpoena. The alias subpoena was issued, served upon the bankrupt and he was adjudicated upon his default. The appellant therein

was a creditor of the bankrupt who obtained an order to show cause why the petition should not be dismissed, which was denied upon the ground that a creditor had no standing to contest the allegations of the petition. The court then said (p. 679),

> "The issues are whether a creditor may, since the Chandler Act amended Section 18(b) of the old Bankruptcy Act, appear and plead to the petition and, if not, whether the court had jurisdiction to make the adjudication upon it."
>
> "The old Act provided in section 18-b that the bankrupt or any creditor might appear and plead to the petition with five days after the return date or within such further time as the Court might allow. In Section 18(b) of the Chandler Act this provision was changed by omitting the words 'or any creditor.' Similarly, section 59f of the old Act gave creditors, other than the original petitioners, the right to enter their appearance at any time and join in the petition or file an answer and be heard in opposition to the prayer of the petition. In section 59(f) of the Chandler Act the words 'or file an answer and be heard in opposition' were left out. These omissions make it clear that Congress did not intend to give a statutory right to creditors to contest the allegations in an involuntary petition. We must take it for granted that the District Court held that the application of the Chandler Act was feasible since it was actually applied and there is no question as to the soundness of that ruling.
>
> "Since there is no longer any express statutory right given creditors to contest an adjudication upon an involuntary petition in bankruptcy, the right, if any, of creditors to make such a contest must rest

upon general principles of equity applicable in bankruptcy proceedings. It is true that such principles will govern action in a bankruptcy court when not in conflict with the statute. Securities Comm. v. U. S. Realty Co., 310 U. S. 434, 457, 42 Am. B. R. (N. S.) 602, at page 617. But where there has been an amendment to the statute whereby such right formerly existent has been withdrawn, there has been the equivalent of a statutory denial of the right and any action under general principles of equity contrary thereto would be contrary to the statute and so erroneous. Consequently, the appellant was without standing to question the sufficiency of the petition."

V.

There Was No Repudiation of Stipulation Re Deposit of Money.

Appellants are in error in stating that there was a repudiation of a stipulation. Appellants state that the $30,000.00 now in the possession of the bankruptcy court was placed there by an adverse claimant under a stipulation that it should be held until the question of whether Abbott Kinney Company was a bankrupt was determined. The $30,000.00 mentioned was paid out by the Executive Committee of the alleged bankrupt after the filing of the petition in bankruptcy. At the time of the payment, it was *custodia legis,* and in the exclusive and complete jurisdiction of the bankruptcy court. Consequently, Brown to whom it was paid was not an adverse claimant, as adverse claimant is used in connection with the exercise of jurisdiction. Furthermore, the stipulation did not provide that the determination of the ownership of said $30,000.00 must await the determination of the bankruptcy petition. It is true the stipulation set a time limit of ten days after

the adjudication or the dismissal of the bankruptcy proceeding within which time steps would have to be taken with regard to the disposition of the $30,000.00, or else disposition should be made in accordance with the stipulation. However, it did not say or infer that a proceeding might not be commenced prior to hearing on the involuntary petition. It simply prescribed an extreme limitation within which the fund might be held without action being taken.

In addition to being the recipient of said sum of $30,000.00 paid to him after bankruptcy, and thereafter placed under the stipulation with the Clerk of the Bankruptcy Court, Brown was likewise a party to the involuntary proceedings, in that it was therein alleged he was the recipient of a preference. The stipulation provided that said petition in bankruptcy should be prosecuted with due diligence. At the time the stipulation was entered into, there was a pending motion [R. 163] by the bankrupt to dismiss the involuntary petition. After the stipulation was entered into, the petitioners in the involuntary proceeding filed an amended petition, and answer to said amended petition was filed. One of the main issues in connection with said involuntary petition was the question of the solvency or insolvency of the corporation. In fact, by the time the trial stage was reached that was the only issue. [R. 155.]

The prime factor in the determination of the solvency or insolvency was the ownership of said sum of $30,000.00, and whether or not the alleged bankrupt owned the sprinkling system free and clear of claim of lien thereon or thereto. [R. 155.] The determination of such ownership was sought through the proceedings now under re-

view as an expeditious and proper method of securing such determination.

In respect to said stipulation, while there appears to be a dispute between the parties thereto as to the time within which proceedings might be instituted to determine the ownership of the said deposit, there can be no dispute as to the express stipulation that the District Court should determine the ownership, unless that Court decided it did not have jurisdiction. The parties to the stipulation precluded themselves from urging the court not to exercise a discretion in accepting a determination of the ownership, but bound themselves to accept a determination if the court decided it had jurisdiction. If it should be deemed that appellee is mistaken in its construction of the stipulation as to the time of commencement of proceedings, nevertheless no real injury was suffered by appellants in that the District Court, even if the proceeding were dismissed. did have jurisdiction to determine such ownership.

In *In re Antigo Screen Door Co.*, 10 A. B. A. 359 (C. C. A. 7), 123 Fed. 249, at p. 251:

> "This being done, and the fund being placed in the registry of the bankruptcy court and in the bankruptcy proceedings, did that court have the right to determine, as a court of bankruptcy and in the bankruptcy proceedings, the respective rights of the parties to that fund? We take it that any court, whether one of equity, common law, admiralty or bankruptcy, having in its treasury a fund touching which there is dispute, may, by virtue of its inherent powers, determine the right to the fund thus in its possession. Jurisdiction in that respect is an incident of every court. Havens & Geddes Co. v. Pierek, Trustee (C. C. A.),

9 Am. B. R. 569, 120 Fed. 244; *In re* McCallum (D. C.), 7 Am. B. R. 596, 113 Fed. 393. If otherwise, every court would be subject to the control of the co-ordinate courts, working havoc to the independence of judicial authority. A fund so possessed, is in *custodia legis* and right to it may only be asserted and determined in the court which possesses it."

In the Matter of Rose Packard Shyvers, 43 A. B. R. (N. S.) 128, D. C. Cal. 33 Fed. Supp. 643, a case where a proceeding under Section 75 of the Bankruptcy Act was dismissed on the ground that the bankrupt-debtor was not a farmer and the fund remained in *custodia legis,* the court said (p 644):

"But assuming that the matter was not pending, still it was the duty of the bankruptcy court, a court of equity, to administer the funds held in *custodia legis,* distributing them to such of the parties, as, after due hearing, might show themselves entitled thereto. This high duty of a court of equity continues after a dismissal of the action on any ground. Especially is this true where, as here, the bank was claiming a lien on the funds in perfect good faith, as shown by the proceedings before the conciliation commissioner. Even though the proceeding be dismissed, the court has ample power to determine their disposition after notice to all parties interested. Jackson v. Lynch (C. C. A. 9th Circ.), 43 Am. B. R. (N. S.) 82, 111 F. (2d) 1003, decided May 10, 1940; Remington on Bankruptcy, Fourth Edition, section 458; *In Re Winship* (C. C. A. 7th Cir.), 9 Am. B. R. 638, 120 Fed. 93. Similarly may be cited Pacific Bank v. Madera Fruit Co, 124 Cal. 525."

VI.

Dismissal of Bankruptcy Proceeding After Order Adjudicating Rights of Ownership in Fund Does Not Vacate Such Order.

Appellants urge that the court erred in not granting their motion to dismiss the entire proceeding relating to the order to show cause and the order to the Referee. (Op. Br. 28.) Appellee knows of no such motion of the appellants. It is true that one Harold B. Poole, a purported creditor filed a motion to dismiss the involuntary petition. [R. 145.] Such motion, however, was made prior to the determination by the District Judge on the review of the Referee's order. Furthermore, no appeal has been taken from the order in respect to such motion. The order of the Referee in this case was made on August 23, 1945, some months prior to the time the special master recommended a dismissal of the involuntary petition on the ground of the solvency of the corporation, and many months prior to the order of the judge approving the special master's report.

It is only common sense that if orders made in the course of a bankruptcy proceeding were to be set aside merely because of a holding that the alleged bankrupt is not insolvent, there would be the utmost confusion in bankruptcy administration. For example, a receiver under the Act is authorized to institute proceedings. In the great majority of cases, the receiver is acting during the time that the involuntary proceeding is pending and before the determination. Can it be said that those orders made during the course of that proceeding, and while the property is under the jurisdiction of the court should be set aside because, perchance, it is later ascertained that the alleged

bankrupt is solvent. The very statement of it would seem to indicate it to be otherwise. The District Judge in his opinion, said:

> "An involuntary petition in bankruptcy has been filed against a corporation within this jurisdiction by three persons who represent that they are creditors and an act of bankruptcy is alleged. True, they may ultimately be determined to be secured creditors and could not qualify as petitioning creditors. On the other hand, they might show that their alleged security was valueless. They might not be able to support the alleged act of bankruptcy, but, while the proceeding was before the bankruptcy court, the bankruptcy court was a court of competent jurisdiction to determine matters pertaining to the property of the bankrupt, and property found in the possession of the bankrupt. No other court during the pendency of the proceeding could, without the consent of the bankruptcy court, entertain litigation in connection with the property of the alleged bankrupt. (Isaacs v. Hobbs Tie & Timber Co., 282 U. S. 734.)
>
> "During the pendency of the proceedings, it would be quite possible and proper for persons to appear in this proceeding claiming to own property in the possession of the bankrupt and request that their property be released to them, and should the court upon the said hearing determine that they were not entitled to the return of the property, and it belonged to the bankrupt, such a determination would be *res adjudicata* in any subsequent proceedings." [R. 180-181.]

See

Sylvan Beach, Inc. v. Kenneth Koch et al., 140 F. (2d) 852, 55 Am. B. R. (N. S.) 409,

where at page 861 (Fed.) it is said:

> "At the time the petition of the Wiemeyers to recover their real estate, and the motion of Koch and Dalton, trustees, to dismiss the reorganization proceeding and to recover the property covered by the deed of trust, were heard, the court below had power to determine whether the Wiemeyers were entitled to the return of their real estate and to the cancellation of their lease, and to decide whether the estate of the debtor had assets which belonged to Koch and Dalton, as trustees, and which should be delivered to them. The court also had power to determine whether the debtor could or could not be reorganized under the Bankruptcy Act, and whether the proceeding had been conducted in good faith or was a fraud upon the court and upon the creditors. . . ."

and at page 862, it is said:

> "The judgment granting to the Wiemeyers possession of their real estate and cancelling the ninety-nine year lease should, we think, be sustained. It is true that the 'judgment' dismissed, for want of jurisdiction, the proceeding as one for corporate reorganization, before granting the relief requested by the Wiemeyers in their petition, but, as we have pointed out, the court had jurisdiction to grant the Wiemeyer's petition for possession of their real estate and did grant it."

VII.

John Harrah and Gerety Each Bore a Fiduciary Relationship to Abbot Kinney Company Which Each Violated, to the Damage of Abbot Kinney Company.

(a) John Harrah Bore a Fiduciary Relationship to Abbot Kinney Company.

Appellants admit that John Harrah was on the Board of Directors and a member of the Executive Committee of, and that he bore a fiduciary relationship to, the Abbot Kinney Company during the controversial period. (Op. Br. 36.) Such being the case, appellee need only point out wherein John Harrah violated his fiduciary obligation.

The Referee found that John Harrah's violation consisted of participating and being the moving force in a conspiracy to cheat and defraud Abbot Kinney Company [R. 72] by having the Executive Committee refuse to purchase the sprinkling system contract, and then having Brown, as undisclosed agent of the conspirators, purchase the sprinkling system contract at as low a figure as he could negotiate and to thereafter have the Executive Committee pay off the contract to Brown as rapidly as possible. [R. 66.] The evidence overwhelmingly supports these findings.

(b) Brown Was an Undisclosed Agent for John and William Harrah.

John Harrah filed a personal voluntary petition in bankruptcy in 1937 but was unable to get relief, although he applied for the same. [R. 297.] Thereafter, he supposedly devoted his entire time, effort and energies to the business of his son, William Harrah. [R. 296, 297.]

About that time Brown came into the picture as the confidant and trusted employee of William Harrah [R. 37] dealing in most instances directly with John Harrah. He had access jointly with John Harrah to William Harrah's safe from which he could remove money at will. [R. 233, 234, 517.] Deals would be negotiated on behalf of William Harrah by John Harrah and then taken in the name of Brown [R. 501-505] and thereafter Brown would confer with John Harrah as to how the business should be operated. [R. 240.] Brown conferred with John Harrah prior to and during negotiations for the purchase of the sprinkling system contract. [R. 252.]

Certainly the foregoing evidence, when coupled with the offer made by John Harrah to Frank Williams and Lou Halper (after Brown supposedly owned the sprinkling system contract) to sell them the same percentage of interest therein as they each held in the bond pool and with the further statement by John Harrah that he "controlled" the sprinkling system contract [R. 514, 515, 523, 524], leads to only one conclusion and that is that after John Harrah was denied his discharge in bankruptcy, he carried on much of his business activities through and in the name of Charles Brown.

The evidence justifies the conclusion that William and/or John Harrah put up at least $5,000 of the $10,000 supposedly paid by Brown for his share of the sprinkling system contract. Brown and Gerety both testified that Brown used two cashier's checks. On close examination

by Referee Brink, Brown was unable to explain why he had obtained two cashier's checks instead of one. [R. 289-292, incl.] Certainly a business man would not ordinarily buy two cashier's checks from the same bank at the same time, payable to the same person, to pay one obligation. The obvious explanation of Brown's actions is that Brown took at least $5,000 out of Harrah's safe and used it as part of the purchase price. This conclusion is strengthened by Al Newton's testimony that Gerety told him that the sprinkling system contract had been purchased by Brown, Gerety and "somebody else" [R. 499], and by the purported subsequent assignment on Nov. 25, 1944, by Brown of an undivided one-third interest in the remainder of the sprinkling system contract to William Harrah. [R. 109, 280 to 285, incl.]

Referee Benno Brink, in orally commenting on this phase of the case at the close of the trial, stated in substance as follows:

> "I am not convinced that Brown has the slightest monetary interest in this transaction. We have a situation here which we sometimes find where a man in financial difficulties seeking relief from the bankruptcy court, is denied that relief. He thereafter functions through a close relative. It is elementary in the bankruptcy court that these are suspicious circumstances. Here is Brown, a very likeable gentleman. He does not give the impression, however, that he would gamble $10,000 of his own money on a contract upon which nothing has been paid since 1932. Nor do I believe he did it. I think the thing is a Harrah deal first, last and all the time." [R. 608-609.]

(c) A Conspiracy to Cheat and Defraud Abbot Kinney Company Existed Between Appellants Herein and John Harrah.

It is well settled in California that in cases of conspiracy to defraud it is not expected that direct evidence of the conspiracy can be secured. This question was thoroughly discussed in the case of *Johnstone v. Morris*, 210 Cal. 580 (292 Pac. 970), where the court said at page 590:

> "In cases of conspiracy to defraud it is not to be expected that direct evidence of the conspiracy can be secured, because such evidence could usually only be secured in the event one of the conspirators confessed. The jury may infer the conspiracy from all the circumstances, and if the inference is a reasonable one it will not be disturbed on appeal. These principles have repeatedly been recognized by this court. In Revert v. Hesse, 184 Cal. 295, at 301 (193 Pac. 943, 946), this court, quoting from a Georgia case, said:
>
> " 'The law recognizes the intrinsic difficulty of proving a conspiracy. The allegations with reference to conspiracy are treated as matters of inducement leading up to a more particular description of the acts from which conspiracy may be inferred. . . . The conspiracy may sometimes be inferred from the nature of the acts done, the relation of the parties, the interest of the alleged conspirators, and other circumstances. . . .'
>
> "On the same page (301) the court continued as follows:
>
> " 'In the present action, while plaintiff was unable to prove any formal agreement between defendants Arthur Hesse and Sidney Beach, nevertheless, there

was before the court the entire transaction resulting in the consummation of a flagrant fraud upon the plaintiff, in which transaction Sidney Beach participated as an intermediary. . . . These cricumstances, coupled with the further fact that defendants Sidney Beach and Arthur Hesse were not strangers, but were no more or less intimate terms, occupying the same office, were sufficient to warrant the inference drawn by the trial court that defendant Sidney Beach was a party to a conspiracy which had for its object the fraudulent conversion complained of by plaintiff.'

"In Beeman v. Richardson, 185 Cal. 280, at page 282 (196 Pac. 774, 775), the rule is stated as follows:

"'The point in connection with the finding as to a conspiracy is that the representations were made by the defendant, Richardson, alone, and that there is no direct evidence that the other defendants agreed that they should be made, or knew at the time that they were being made. But direct evidence of that character could hardly be had in the very nature of things, unless one of the defendants should confess, and the fact must be determined by the inference naturally and properly to be drawn from those matters which can be, and are directly proven.'

"Under the evidence partially summarized, *supra*, the inference of joint fraud was not unreasonable, and will not be disturbed on appeal."

It is hard to believe that John Harrah, who was interested primarily in the bonds of the Abbot Kinney Company [R. 508, 509, 122, 492, 493, 513] would eagerly pay out $37,500 cash of the Abbot Kinney Company on

a contract which had been offered to the Abbot Kinney Company for $10,000 on two different occasions [R. 491, 496, 497, 498], which had been in default for many years [R. 303, 388], which was junior in position to the bonds [R. 492, 493], and which was purchased for only $15,000 [R. 256, 258], unless he was benefitting thereby. His admission to Lou Halper and to Frank Williams that he "controlled" the contract [R. 514, 515, 523, 524] is the only explanation for John Harrah's actions.

Brown would not have risked $10,000 which, according to his own evidence, represented a substantial portion of his assets [R. 221-232, incl.] on a sprinkling system contract which had long been in default and junior to a large bonded and tax indebtedness, unless he had absolute assurance that someone in authority in Abbot Kinney Company would protect him against loss, or unless he was not risking his own money but was merely acting as agent for and under the direction of someone else.

Gerety, in his capacity as manager, state receiver, trustee and again manager of Abbot Kinney Company continuously since 1926 [R. 433-436, incl.], could not help but know: that Abbot Kinney Company had paid no bonded interest since 1932 and owed more than $75,000 in taxes, $269,000 principal of bonds, and in excess of $225,000 in bond interest; that the sprinkling system contract was junior to the bonds, had been in default since 1932 and had been offered to Abbot Kinney Company for $10,000, but had been refused by John Harrah; that Lou Halper and John Harrah were primarily interested in protecting the bond position and had refused to pay anything on account of the sprinkling system contract although many requests for payment had been made by

Cruickshank & Co. With this knowledge, Gerety would not have risked $5,000 to purchase a one-third interest in said sprinkling system contract, unless he had a commitment from John Harrah which assured his reimbursement and a nice profit.

Referee Brink, in his oral summation on this phase of the case, stated in substance as follows [R. 605 to 608, incl.]:

> "I am satisfied beyond a reasonable doubt that here was an unconscionable conspiracy and confederation, headed by John Harrah, to gain an advantage for himself over the other people with whom he was connected in Abbot Kinney Company. For many years he had taken the position, and with sound reason, that no money should be paid on the sprinkling system contract unless absolutely necessary since it would be disadvantageous to the bondholders. He had a right to take that position. Everyone connected with the set-up knew that he represented the bondholders. The other people in the picture were able to take care of themselves. Therefore, it cannot be said that John Harrah was recreant in his duty because he looked out for the bondholders. In spite of this, we find that no sooner had the sprinkling system contract been purchased, than $7500 is paid on account. Now why? Because, by a strange coincidence, the Cruickshank Company had at the same time, sent a letter threatening to turn off the water. The attorney who prepared that letter and caused it to be sent, testified it was merely for the purpose of establishing a technical default. So Brown walks into a meeting of the Executive Committee, at which all members of the committee are not present, and

says, 'I am going to turn off the water unless I get $7500; and if I get $7500, I won't turn it off for three months hence.'

John Harrah had known all through the years that under the terms of the sprinkling system contract there was a provision that the water could be turned off, the pipes repossessed and the system torn out. It wasn't any news to him. I venture to say that if a representative of Cruickshank & Co. or anyone other than someone John Harrah was in league with had walked in and made such demand, John Harrah would have literally thrown him out of the office. He wouldn't have received a dime. But imagine—although John Harrah knew that there were forces in the corporation that had been urging that the corporation purchase the sprinkling system contract for the nominal sum of $10,000, still John Harrah, with the assistance of Carleton Kinney, who permitted himself to be used in the matter, immediately wrote out a check for $7500 without even getting back a statement from Brown to the effect that at least three months' grace would be given. Then when John Harrah knew that his power as a member of the Executive Committee was to end the next day, Brown again, by a strange coincidence, writes a demand dated November 6th for $30,000. John Harrah again with the gracious assistance of Carleton Kinney, immediately writes out a check for $30,000 and delivers it to Brown. They were in such a hurry to get the check cashed by the bank that the physical evidence shows that the check was never even folded once, nor one even as much as put it in his pocket or in his purse or billfold. It was either delivered directly to the banking house of the Security Bank or was taken post-haste by Brown to the bank in order to get it in his account or cash it.

If John Harrah were not an interested party in this transaction, would he have forthwith paid that $30,000? Certainly there would have been every reason favoring his delay until the next day when he could place the responsibility on the shoulders of the stockholders. No man would have assumed that responsibility of paying out $30,000, at least 75% of all the cash resources of Abbot Kinney Company, at that time. Particularly in view of his interest as a bondholder in Abbot Kinney Company. The conclusion is inescapable that this is an unconscionable deal engineered by John Harrah."

(d) Gerety Bore a Fiduciary Relationship to Abbot Kinney Company.

Appellants contend that Gerety owed no fiduciary obligation to Abbot Kinney Company. The very statement of his position, however, is a complete answer to their contention.

Gerety was first employed as general manager of Abbot Kinney Company in 1926. He held that position until 1932 when he was appointed its Receiver. He continued as Receiver until 1937 when he was appointed its Trustee in Bankruptcy under 77B proceedings. This proceeding was shortly dismissed and Gerety was again appointed the general manager which position he held until November 15, 1944. [R. 433 to 436, incl.] The above facts are not in dispute.

Alfred A. Newton described the duties of Gerety as manager substantially as follows [R. 490]:

"Gerety's duties as manager were to represent the company before meetings at which the company had to be represented, to take up tax matters before the Board of Supervisors, to hire and fire employees, to

recommend to the Board of Directors and to the Executive Committee deals for the sale and leasing of property, and to handle all of the normal business of the company—Whenever the company dealt with the tenants, Gerety made his recommendations, carried out the instructions given him, or took whatever action was necessary."

Brown testified that whenever he wanted anything from, or information regarding Abbott Kinney Company, he went to Gerety, who so far as Brown knew, was in full charge of the activities of Abbot Kinney Company. [R. 241.]

Gerety testified that he had charge of the office, looked after the workmen [R. 434], carried on negotiations for leases, saw that they were performed by the tenants [R. 444, 445]; that he had the books of Abbot Kinney Company under his control and direction. [R. 437.] Thus, Gerety's position with Abbot Kinney Company was one of trust and confidence.

In such position Gerety was obligated to be candid with the officers and directors of Abbot Kinney Company on any business of the company. In violation of that obligation, Gerety deliberatedly misled Al Newton, a director and member of the Executive Committee of Abbot Kinney Company.

Al Newton testified that he had a conference with Gerety on Tuesday, June 6, 1944, at which time he told Gerety that he thought Abbot Kinney Company should purchase the sprinkling system contract for $10,000 and requested Gerety's help in persuading John Harrah to consent to it, to which Gerety agreed. [R. 496.] Seven days later Gerety, according to his own admission, bought

the contract for his own account and the account of others after having carried on negotiations for several days. [R. 256, 258, 448.]

If Gerety had performed his fiduciary obligation to Abbot Kinney Company, he would have told Newton at that time that he, Gerety, Brown and someone else, were seriously negotiating for the purchase of the sprinkling system contract, and that he wasn't interested in, nor would he endeavor to persuade John Harrah to consent to its purchase by Abbot Kinney Company.

Appellee respectfully submits that there could be no more flagrant violation of a fiduciary obligation than the one in which Gerety participated. It was just another element, however, of the conspiracy. Certainly this evidence is more than sufficient to support the finding that Gerety violated his fiduciary obligation to Abbot Kinney Company.

Aside from Gerety's specific obligation to be candid with Newton, and assist him in his effort to protect the interests of Abbot Kinney Company when specifically requested to do so, Gerety should not be permitted to profit at the expense of his principal, who for these past many years has maintained him in a position of confidence. We do not believe that any of the cases cited by appellants justifies Gerety buying an interest in the sprinkling system contract for his own account without first receiving a complete approval so to do from Abbot Kinney Company.

(e) Gerety Participated in and Was a Part of the Conspiracy.

According to Brown, it was Gerety who first called the sprinkling system contract to Brown's attention and made the date with Hugh Darling to discuss its purchase. [R. 242, 245, 252, 253, 448.] Gerety told Brown that from his (Gerety's) past experience and connections with Abbot Kinney Company, he felt the sprinkling system contract was good. [R. 249.] Gerety participated in the negotiations with Hugh Darling to purchase the sprinkling system contract. [R. 254, 255.] After the negotiations were started, it was Gerety who received word from Darling that the sprinkling system contract could be purchased and the price therefor. [R. 257.] Gerety agreed that the assignment would be taken in Brown's name alone and that Brown would thereafter assign a one-third interest therein to Gerety. [R. 260.] Gerety knew how much money Abbot Kinney Company had when the sprinkling system contract was purchased. [R. 450.] When the first demand was made upon Abbot Kinney Company for payment on account, Gerety suggested to Brown that they ask for $7500. [R. 264.] Gerety received $2500 of the first payment of $7500. [R. 267] and $10,000 of the second payment of $30,000. [R. 279.] Gerety and Brown discussed the demand for $30,000 before Brown made it. [R. 457.] Gerety received the notice to Abbot Kinney Company from Cruickshank & Co. stating that it was going to turn the water off. [R. 332.] Gerety was familiar with the financial status of Abbot Kinney Company and always knew how much money was on hand. [R. 344.] Gerety told Brown the sum Abbot Kinney Company had on hand when the demand for $30,000 was made. [R. 347.]

Thus, Gerety played a major role in formulating and consummating the conspiracy.

(f) Neither John Harrah Nor Gerety Could Traffic in Claims Against Abbott Kinney Company.

It is well settled that a fiduciary cannot purchase the debts of his corporation at a discount. Particularly is this true where the corporation is insolvent. This was clearly pointed out in *Davis v. Rock Creek L. F. & M. Co.*, 55 Cal. 364, 36 Am. Rep., where the court said:

> "The law, for wise reasons, will not permit one who acts in a fiduciary capacity thus to deal with himself in his individual capacity. The position of A. Wolf as a member of the firm of A. Wolf & Co., and his position as trustee and president of the corporation defendant, were inconsistent and conflicting. In purchasing the debts of the corporation in his individual capacity, it was to his interest to buy them at as great a discount as possible. The greater the discount the greater his gain. If he succeeded in purchasing the debts at ANY discount, to that extent he secured to himself an advantage not common to all of the stockholders. To permit this to be done would be to permit the violation of one of the plainest principles of equity applicable to trustees. . . . (Andrews v. Pratt, 44 Cal. 309; San Diego v. S. D. and L. A. R. R. Co. 44 id. 106; Wilbur v. Lynde, 49 id. 290; Picket v. School District No. 1, 25 Wis. 552; Cumberland Coal Co. v. Sherman, 30 Barb. 553; Aberdeen Railway Co. v. Blakie, 1 MacQueen, 461; Field on Corp. Sec. 174 and 175, and authorities there cited.)"

In *Lowe v. Copeland*, 125 Cal. App. 322 (13 Pac. (2d) 522), the court said:

> "The president and the directors of a corporation occupy a fiduciary and trust relationship thereto (Sims v. Petaluma Gas-Light Co., 131 Cal. 656 (63

Pac. 1011); Pacific Vinegar etc. Works v. Smith, 145 Cal. 352 (104 Am. St. Rep. 42, 78 Pac. 550), and they are not permitted to assume a position adverse to the corporation (Dean v. Shingle, 198 Cal. 652 (46 A. L. R. 1156, 246 Pac. 1049). Transfers of corporate property by such officers to themselves are voidable (6a Cal. Jur., Corporations, sec. 633; Phillips v. Sanger Lumber Co., 130 Cal. 431 (62 Pac. 749); Dean v. Shingle, *supra*); and a trust arises in favor of the corporation as against an officer as to anything so received (Lezinsky v. Mason Malt etc. Co., 185 Cal. 240 (196 Pac. 884)."

Also in *Bonney v. Tilley,* 109 Cal. 352 (42 Pac. 439), it was stated:

"It seems to be well settled that directors of an insolvent corporation, who are creditors of the company, cannot secure to themselves any preference or advantage over other creditors in the payment of their claims. (Hays v. Citizens' Bank, 51 Kan. 535; Beach v. Miller, 130 Ill. 162; 17 Am. St. Rep. 291; Adams v. Kehlor Milling Co., 35 Fed. Rep. 433; Hopkins' Appeal, 90 Pa. St. 69.)

In Cook on Stock and Stockholders, section 660, it is said: 'It is a fraud on the corporation and on corporate creditors for the directors to buy up at a discount the outstanding debts of the corporation and compel it to pay them the full face value thereof. In such a case the directors may be compelled to turn over to the corporation the evidences of indebtedness upon being paid the money which they gave for the same.' "

See also *Kahle v. Stephens,* 214 Cal. 92 (4 Pac. (2d) 145).

It is to be noted that under the California definition of insolvency, Abbot Kinney Company was insolvent in that it was unable to pay its debts from its own means, as they became due. (Code Civ. Proc. 3450 and 1796(3).)

The evidence is uncontroverted that Abbot Kinney Company had not been able to pay its taxes, its bond interest or the sprinkling system contract, from its own means, as they became due. On this subject John Harrah testified that the operation of Abbot Kinney Company was not profitable, that the company had paid nothing on its bonds since 1932, and that the tax situation had been very bad. [R. 305.] Therefore, under the laws of California, Abbot Kinney Company has been insolvent ever since 1932. The insolvency of Abbot Kinney Company is a complete answer to all of the cases relied upon by Appellants in their Opening Brief in support of their argument that Gerety as manager had a right to traffic in the claims of the Abbot Kinney Company. (Op. Br. 40-46, incl.) None of said cases justifies a director or confidential employee dealing in claims against his corporation where it is insolvent. There is another complete answer to such cases in that each thereof is also predicated upon the further premise that there was an "absence of fraud" on the part of such director or employee. For example, the case of *Todd v. Temple Hospital Assn. Inc.*, 96 Cal. App. 43, (273 Pac. 595) (Op. Br. 42), the District Court of Appeal said:

> *"In the absence of fraud or inequitable circumstances* (italics ours) the rule that it is a violation of his trust for an officer to deal with the corporation applies only where his conduct is in the nature of an attempt to unite his personal and representative characters in the same transaction and where his

official connection is an essential part of the corporate action."

The facts herein can justify only one conclusion and that is that there was fraud and inequitable circumstances in the dealings of John Harrah and Gerety with Abbot Kinney Company to the advantage of the former and detriment of the latter.

VIII.

Brown Cannot Profit From Violation of the Fiduciary Obligation Owed by John Harrah and/or Gerety to Abbot Kinney Company.

Appellee concedes that at the time Brown obtained the assignment of the sprinkling system contract from Cruickshank & Co., he held no position of trust with Abbot Kinney Company. This, however, does not relieve Brown from liability to account to Abbot Kinney Company in the present matter, since he knew that John Harrah was a director and a member of the Executive Committee of Abbot Kinney Company [R. 235] and that Gerety was its manager and in full charge of its activities [R. 241] at the time the fraud upon Abbot Kinney Company was committed. This problem has been considered by the California Appellate Courts on many occasions. See *Smith v. Blodgett,* 187 Cal. 235 (201 Pac. 584); *Fink v. Weisman,* 129 Cal. App. 305 (18 Pac. (2d) 961); *Lomita Land & Water Co. v. Robinson,* 154 Cal. 35 (97 Pac. 10); *Victor Oil Co. v. Dunn,* 184 Cal. 226 (193 Pac. 243).

In *Smith v. Blodgett, supra,* the court said (p. 242):

> "And where, after the violation of a fiduciary obligation, an accounting is had and an amount found to be due from the agent or trustee, judgment for

the same amount may also be rendered against those proven to have fraudulently aided in the attempt of the fiduciary to obtain secret profits, although they themselves are not fiduciaries and receive no share of the profits."

Also in *Lomita Land & Water Co. v. Robinson, supra,* the court said (p. 46):

"It is not essential to such a liability that such participant was originally a party to the contrivance of the fraud. If knowing the fraud contrived, he willfully aids in its execution, he thus becomes a party to the plan and is chargeable with the consequences. (See Lincoln v. Chafflin, 7 Wall. 138, (19 L. Ed. 106).) All persons uniting or cooperating in such a wrong are jointly liable for ensuing injury, irrespective of the degree of culpability. (See Marrott v. Williams, 152 Cal. 705, 93 (Pac.) 875, and cases cited therein; 3 Cooley on Torts, 213; More v. Finger, 128 Cal. 319 (60 Pac. 933).) As said by the learned Judge of the court below: 'It is not necessary that the defendants shall have all been in league from the beginning to defraud the investors, or any of them; they need not be *in pari delicto.* It is enough that each was at some time and in some degree a party to and aided the improper transaction and it matters not how unequal may have been the assistance rendered.' Nor is it even essential that such a participant should have shared at all in the profits of the fraud." (See also *Geddes v. Anaconda Copper,* 254 U. S. 590, 65 L. Ed. 425; *Jackson v. Smith,* 254 U. S. 586, 65 L. Ed. 418)

IX.

The District Court Did Not Err in Modifying the Findings of the Referee.

Appellants urge that "the court erred in modifying the Findings of the Referee and in finding that Abbot Kinney Company had the opportunity of acquiring said sprinkling system contract for the sum of $10,000." (Op. Br. p. 31.)

The District Court did not modify the Findings of the Referee to the effect that Abbot Kinney Company had the opportunity of acquiring the sprinkling system contract for the sum of $10,000. [R. 67, Finding XIV, R. 71, Finding XXIV], but to the contrary confirmed, accepted and adopted the same as part of the court's Findings of Fact. [R. 188.]

The District Court did, however, reject, reverse and modify Finding XXXII and Conclusions of Law V and VI and that portion of the Order respectively of Referee Brink, which provided that Brown was entitled to receive $7500 of the $30,000 on deposit and substituted therefor its own Finding, Conclusions of Law and portion of Order, which provided that Brown was entitled to receive only $2500 of the $30,000 on deposit. [R. 189, 190, 191, 192.]

The District Court not only had the right to do this but the duty and obligation so to do because the Referee's Finding, Conclusions of Law and portion of Order in this respect was clearly error. According to Sec. 2a (10) of the Bankruptcy Act, the "records, findings and order" certified to the Judge by the Referee may be confirmed, modified, reversed or returned with instructions for further proceedings by the reviewing District Judge. Gen-

eral Bankruptcy Order No. 47 states that "The judge after hearing, may adopt the report or may modify it or may reject it in whole or in part."

In the matter of Sparta Canning Co. (C. C. A. 7th Circuit) 73 F. (2d) 732, 27 Am. B. R. (N. S.) 188, the court held that in view of the extremely broad power conferred by Sec. 2 a (10), the District Judge may amend and add to the Findings of the Referee. Under this broad grant of power, the reviewing judge is not barred from considering any issue presented by the record even though it was not discussed by or before the Referee. (See Collier on Bankruptcy, 14th Ed. Vol. II, page 1496, par. 39.28; also see *In re Wilde's Sons* (C. C. A. (2d) Cir.) 144 Fed. 972, 16 Am. B. R. 386; *Matter of Elmore Cotton Mills* (D. C., Ala), 217 Fed. 810, 33 Am. B. R. 544; *In re Clay* (C. C. A., 1st Cir.), 192 Fed. 830, 27 Am. B. R. 715; *In re Pettingill & Co.* (C. C. A., 1st Cir.) 137 Fed. 840, 14 Am. B. R. 757.)

The only limitation imposed on the scope of review by the District Judge is the statement in General Bankruptcy, 47, that "the Judge shall accept his (the Referee's) Findings of Fact unless clearly erroneous." In this instance, the Findings of Fact and Conclusions of Law rejected by the District Court were "clearly erroneous." The Referee made another Finding that the Abbot Kinney Company would have purchased the sprinkling system contract on June 6, 1944 for $10,000 if it had not been prevented from doing so by the conspiracy instigated, conceived and executed by the Appellants herein and John Harrah, and that it would have been for the best interests of Abbot Kinney Company to have made such purchase. [R. 71, Finding XXIV.] From this, the Referee should have found that the maximum sum which

Brown could recover from Abbot Kinney Company was a total of $10,000. Otherwise the Abbot Kinney Company would be penalized by the fraud of the conspirators. The District Court recognized this principal and corrected the error of the Referee. [R. 183-4.]

Conclusion.

Because Abbot Kinney Company, the alleged bankrupt, was in possession of the subject matter of this controversy at the time of the filing of the petition in bankruptcy, to wit: the $30,000 and the sprinkling system, the District Court, as a court of bankruptcy, had exclusive jurisdiction to determine all controversial questions relative thereto. The evidence in this case is replete with fraud of the appellants herein and of John Harrah of the most flagrant nature and fully justifies and supports the District Court in making the order that appellants complain of in this appeal.

Appellee respectfully submits, therefore, that the order of the District Court should be affirmed.

Respectfully submitted,

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APPENDIX.

Collier on Bankruptcy, 14th Ed., Vol. (2), General Orders in Bankruptcy, Rule 47,—Reports of Referees and Special Masters:

Unless otherwise directed in the order of reference the report of a referee or of a special master shall set forth his findings of fact and conclusions of law, and the judge shall accept his findings of fact unless clearly erroneous. The judge after hearing may adopt the report or may modify it or may reject it in whole or in part or may receive further evidence or may recommit it with instructions.

Collier on Bankruptcy, 14th Ed., Vol. (1), Chapter II, Section Two: U. S. C. Ann. Title 11, Chap. 2, Sec. 11.

a. The courts of the United States hereinbefore defined as courts of bankruptcy are hereby created courts of bankruptcy and are hereby invested, within their respective territorial limits as now established or as they may be hereafter changed, with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in proceedings under this title, in vacation, in chambers, and during their respective terms, as they are now or may be hereafter held, to—

(1) Adjudge persons bankrupt who have had their principal place of business, resided or had their domicile within their respective territorial jurisdictions for the preceding six months, or for a longer portion of the preceding six months than in any other jurisdiction, or who do not have their principal place of business, reside, or have their domicile within the United States, but have property within their jurisdictions, or who have been adjudged

bankrupts by courts of competent jurisdiction without the United States, and have property within their jurisdiction;

(7) Cause the estates of bankrupts to be collected, reduced to money and distributed, and determine controversies in relation thereto, except as herein otherwise provided, and determine and liquidate all inchoate or vested interests of the bankrupt's spouse in the property of any estate, whenever under the applicable laws of the State, creditors are empowered to compel such spouse to accept a money satisfaction for such interest;

(10) Consider records, findings, and orders certified to the judges by referees, and confirm, modify, or reverse such findings and orders, or return such records with instructions for further proceedings:

b. Nothing in this section contained shall be construed to deprive a court of bankruptcy of any power it would possess were certain specific powers not herein enumerated. As amended May 27, 1926, c. 406, Sec. 2, 44 Stat. 662; June 22, 1938, c. 575, sec. 1, 52 Stat. 842.

UNITED STATES CODE ANNOTATED—Title 28—page 401
RULE 8, GENERAL RULES OF PLEADING.

(a) CLAIMS FOR RELIEF. A pleading which sets forth a claim for relief, whether an original claim, counterclaim, cross-claim, or third-party claim, shall contain (1) a short and plain statement of the grounds upon which the court's jurisdiction depends, unless the court already has jurisdiction and the claim needs no new grounds of jurisdiction to

support it, (2) a short and plain statement of the claim showing that the pleader is entitled to relief, and (3) a demand for judgment for the relief to which he deems himself entitled. Relief in the alternative or of several different types may be demanded.

California Civil Code, Section 3450.

"Insolvent" Defined.—A debtor is insolvent, within the meaning of this title, when he is unable to pay his debts from his own means, as they become due. Leg. H. 1872.

California Civil Code, Section 1796 (3).

Definitions (3) A person is insolvent within the meaning of this act who either has ceased to pay his debts in the ordinary course of business or cannot pay his debts as they become due, whether he has committed an act of bankruptcy or not, and whether he is insolvent within the meaning of the federal bankruptcy law or not.